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When A Business Fails – Who Gets What?

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I. Overview

A great percentage of businesses will fail.

For those of us who make our living dealing with the fallout from business failures, the reasons for the failure and the nuances of each business may vary but there is a commonality among the types of economic stakeholders and their rights to share in whatever assets remain of the failed business enterprise.

"What will I get?" This is invariably one of the first questions I am asked by a client - whether I am acting for a business owner, secured creditor, landlord or supplier.

In the case of the business owner, the answer is usually easy (and never what the owner wants to hear). With the other stakeholders, the answer will depend upon a number of factors, including the type of assets involved and the number and nature of the competing claimants.

This brief paper will provide a fairly high level overview of the usual stakeholders one encounters following a business failure and a discussion of their respective rights and ranking in the hierarchy of claimants who find themselves competing to get a share of what assets remain in the carcass of the failed business.

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II. The Crown

It should come as no surprise that the Crown - both federal and provincial - are almost certainly found on the list of creditors owed money by an insolvent corporation.

Shocking as it may seem, when money gets tight, business operators tend to pay their suppliers, employees and generally everyone else before the government.

Identifying this as a disturbing trend, the federal and provincial governments both enacted legislation in the 1990s designed to make sure they had a chair when the music stopped. And so the legal fiction of a "deemed trust" was created.[2]

Deemed trusts are a very powerful weapon in the arsenal of the federal and provincial Crowns. Unlike the interests of secured creditors that are created through an express agreement with a borrower, the federal and provincial Crowns derive their authority and priority by legislation that requires no participation or agreement by a tax debtor. Indeed, in many cases, the existence of a deemed trust does not become apparent until insolvency proceedings are commenced.

Generally, "deemed trust" legislation operates as follows:

(a) there is a charging provision that deems all property of a tax debtor situate in Canada to be held in trust up to the amount of all unremitted tax arrears;

(b) the deemed trust is given a super-priority over all competing "security interests" in the same collateral. This includes mortgages; and

(c) the legislation then prescribes certain limits to the extent of the super-priority interest against real property mortgage holders by creating a so-called "prescribed security interest" - which is defined in the legislation and discussed in a little more detail below.

The "deemed trust" is a legal fiction as it is created solely by the language of the governing statute and would not otherwise be considered a trust under general trust law principals. The trust covers both real and personal property and where property impressed with the trust is sold to a third party, the Crown has the right to trace its interest into the sales proceeds. However, it is important to note that there is no right for the Crown to pursue third party purchasers and no ability to attach against the purchased property.[3]

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[2] My former colleague, Eleonore Morris, wrote an excellent paper in February of 2013 entitled "Understanding Crown Priorities In Insolvency" in which she discusses the genesis and impact of the deemed trust legislation.

[3] See *First Vancouver Finance v. MNR* [2002] 2 S.C.R. 720 ("**First Vancouver**").

The most commonly encountered deemed trusts involve:

A. Employee Source Deductions

Employee source deductions refer to amounts that an employer is required to deduct from an employee's wages for income tax, employment insurance and Canada Pension Plan ("**CPP**") contributions.

At the time the *Income Tax Act* ("**ITA**") was amended to include the deemed trust provisions, representatives of Canada Revenue Agency and the Department of Justice embarked on a nationwide road show to explain the new concepts and why they were of such importance to Canadians. At that time, source deductions comprised 85% of the national tax base and it is not surprising that the Supreme Court of Canada in *First Vancouver* has remarked that source deductions are "at the heart of income tax collection in Canada".

Subsection 227(4) of the ITA provides the Crown with a super-priority right to recover against all property of a tax debtor for amounts owing for income tax arrears which were deducted from employee wages but not remitted by an employer. The deemed trust arises at the time that the employer fails to remit and continues until all arrears are paid. No action is required on the part of the Crown to effect the deemed trust - the deemed trust is automatic.

Under the provisions of subsection 227(4.1) of the ITA, the Crown is granted the right to recover first against all of the tax debtor's property, in priority to all other "security interests" - which is broadly defined to include all charges and liens of every nature and kind. The only exception to this super-priority is found in subsection 227(4.2) of the ITA which carves out a "prescribed security interest" from the definition of "security interest". The scope of this exception is discussed in Section C below.

Similar super-priority provisions are found in section 86 of the *Employment Insurance Act* ("**EIA**") and section 23 of the CPP for remitted employment insurance and CPP contributions respectively.

B. HST / GST

Subsection 222(1) of the *Excise Tax Act* ("**ETA**") creates a deemed trust for collected but unremitted HST/GST. This trust is impressed upon all personal and real property of a tax debtor. Accordingly, notwithstanding any "security interest" which may otherwise affect the assets of a tax debtor, all monies received by the tax debtor are deemed to be held separate and apart from all other property of the debtor.

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Subsection 222(3) of the ETA allows the Crown to trace its interest in HST/GST arrears in and to any cash on hand and any proceeds of sale of a debtor's property and to recover against such cash and proceeds in priority to all "security interests" in the same property.

Like the ITA, subsection 222(4) of the ETA carves out an exception for a "prescribed security interest" in s. 2201 of Income Tax Regulations.

C. The "Prescribed Security Interest"

In order to protect an innocent third party mortgage lender (who has not benefitted by the failure of a tax debtor to remit), the enabling legislation creating the deemed trust interest also contains an exception for those lenders that have a "prescribed security interest".

A “prescribed security interest” is defined as a mortgage on land or a building that was given and registered before the deemed trust arose.

In short, a lender with a “prescribed security interest” will rank ahead of the Crown up to the amount of the “prescribed security interest” (as determined by the regulations). Notably, the protected amount is usually lower than most mortgage lenders believe it to be.

The amount of the prescribed security interest is equal to:

- the amount of the obligation outstanding under the mortgage at the time of the failure by the debtor to remit the payroll deductions or HST; minus
- the value of all other security interests held by the mortgagee, calculated as at the time of the failure remit; and
- all amounts applied by the mortgagee after the time of the failure to remit (for example; all mortgage payments received after a deemed trust arose).

Unfortunately, unlike construction liens, there is no search mechanism in place for a mortgage lender to determine the existence of a deemed trust before advancing funds. Indeed, the Crown usually only learns of a deemed trust entitlement after a payroll or HST audit is conducted. It is the invisibility of the deemed trust arrears that causes problems for lenders.[4]

[4] Many mortgage lenders have adopted the practice of requiring title insurance as part of their loan commitments. Most title insurance products will cover the mortgagee against any deemed trust liabilities that are found to exist at the time of the initial mortgage advance.

D. Impact of A Bankruptcy Or A Proposal

Generally speaking, the occurrence of a bankruptcy or the compromise of debts through a *Bankruptcy and Insolvency Act* (Canada) ("**BIA**") proposal process will render Federal and Provincial Crown claims unsecured.

This general principle is subject to certain significant exceptions in respect of deemed trusts created for source deductions and Crown claims that are perfected by registration under prescribed registry systems.

Sections 86 and 87 of the BIA identify three kinds of Crown interests which will continue to be enforceable following a bankruptcy or when a debtor makes a proposal to its creditors. Specifically:

- claims that are secured by a security or charge of a kind that can be obtained by persons other than the Crown pursuant to (a) any law, or (b) any federal or provincial legislation where the federal or provincial provisions have not solely been created to secure the Crown claim;
- secured claims that are created in federal or provincial legislation for the sole purpose of securing a Crown claim, provided that (a) the Crown interest has been registered under the prescribed registry system before the bankruptcy of proposal filing and (b) the Crown will only have priority for the amount of the arrears owing as at the date of the filing; and
- Crown claims for payroll source deduction obligations under the ITA, CPP and EIA.

Priority for HST and Provincial Crown garnishment orders affecting a debtor's accounts receivable are defeated by the provisions of section 86 of the BIA. Similarly, priority for Federal Crown garnishment orders will also be defeated unless an exemption from section 86 or the BIA generally is provided for under the relevant federal statute or a proprietary right is created in the garnished funds.

It should be noted that the Ontario Court of Appeal in Ivaco[5] provided that it is not improper for a secured creditor or other stakeholder to seek a bankruptcy order for the purpose of reversing a statutory deemed trust or other similar super-priority of the Crown. Depending upon the quantum of the HST arrears, the ability of a secured creditor to reverse priority through a bankruptcy can be a determinative factor in whether a debtor becomes a bankrupt.

[5] [2005] O.J. No. 3337, 12 C.B.R. (5th) 213 (Ont. S.C.J. – Commercial List) at para. 11, [2006] 25 C.B.R. (5th) 176 O.J. No. 4152 (Ont. C.A.)

III. Secured Creditors

Unlike the super-priority interests that are granted to the Crown by statute and which require no action on the part of the Crown, the rights of a secured creditor are derived by way of a contract with the debtor.

A. The Security Interest

The scope of the security interest afforded to the secured creditor is solely determined by the language of the security agreement entered into with the debtor.

In Ontario, the requirements for the creation of a security interest in personal property between a debtor and a secured creditor and the steps necessary to perfect this security interest and thereby make it effective against the interests of third parties are all set out in and governed by the *Personal Property Security Act* (Ontario) ("**PPSA**"). For real property security interests, the *Mortgages Act* is the governing legislation. In this paper, I will only address the personal property security regime.

An enforceable security agreement does not have to be a complex document. It simply needs to be an agreement that "creates or provides for a security interest and includes a document evidencing a security interest".[6]

Section 1(1) of the PPSA, the term "security interest" is defined as "an interest in personal property that secures payment or performance of an obligation, and includes, whether or not the interest secures payment or performance of an obligation,

(a) the interest of a transferee of an account or chattel paper, and

(b) the interest of a lessor of goods under a lease for a term of more than one year."

The basic principles of contract law apply. To be valid as between the two contracting parties, there must be an offer, acceptance and consideration. In addition, for the security agreement to be of any real value it needs to identify the collateral being secured with sufficient specificity to allow identification of such collateral and thereby preclude ambiguity as to entitlement should enforcement be necessary.

[6] Subsection 1(1) PPSA.

In order to create a security agreement that is binding upon not only the debtor but also third parties, the secured creditor needs to ensure that all steps needed to comply with the attachment and perfection provisions of the PPSA are complied with.[7]

For our purposes, it is sufficient to conclude that a lender may protect its advances by properly taking security from a debtor and if all steps are complied with this security will defeat the interests of unsecured creditors.[8]

B. Purchase Money Security Interests ("PMSI")

The general rule governing priority among secured creditors who have interests in the same collateral is based upon who perfects their security interest first. Whether perfection is by way of registration or possession.

However, the PPSA also provides a mechanism that allows secured creditors to get a first ranking position in collateral that they specifically finance. This interest is called a PMSI.[9]

A properly perfected PMSI has a first priority security interest in the subject collateral to the extent to which the secured creditor has given value to the debtor to acquire the collateral.

A PMSI is defined in section 1(1) of the PPSA as:

> (a) "a security interest taken or reserved in collateral, other than investment property, to secure payment of all or part of its price,
>
> (b) a security interest taken in collateral, other than investment property, by a person who gives value for the purpose of enabling the debtor to acquire rights in or to the collateral, to the extent that the value is applied to acquire the rights, or
>
> (c) the interest of a lessor of goods under a lease for a term of more than one year,

but does not include a transaction of sale by and lease back to the seller."

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[7] A discussion of the concepts of attachment and perfection and the many issues that can arise for secured creditors with respect to the same is beyond the scope of this paper.

[8] Subject to certain special statutory protections for unsecured creditors such as revendication rights under section 81.1 of the BIA.

[9] It should be noted that operating lenders with a general security interest in the assets of a debtor will typically require that the borrower get consent or at least notify them before contracting with a PMSI lender.

Reference needs to be made to section 33 of the PPSA to determine the timing and necessary steps to ensure PMSI status is obtained.

Without going into great detail, it should be noted that to obtain a PMSI over inventory, all steps must be completed before the debtor has possession of the collateral. For example, a security agreement needs to be signed, registration needs to be effected and a prescribed form of notice needs to be given to every secured creditor who has an interest in the same collateral.

For non-inventory PMSI interests, no notice needs to be given to other secured creditors and the security interest need only be perfected no later than 10 days after the debtor receives possession of the collateral.

If the technical requirements of the PPSA are complied with, the PMSI is an effective tool to ensure that a secured creditor obtains a first ranking interest in the collateral it finances.

C. Intercreditor Agreements

For businesses today, it is not uncommon to finance operations and other strategic requirements with funds received from more than one secured lender.

An Intercreditor Agreement between two of more such lenders is useful in setting out the relative rights and priorities between these lenders. Indeed, such an agreement is typically viewed by lenders as a critical requirement as it helps to avoid ambiguity relative to entitlement in an enforcement scenario.

A number of the matters typically addressed in an Intercreditor Agreement are set out below:

- establish priorities to various classes of collateral and regulate when enforcement can be undertaken by a lender and what notice is required to be given to the debtor and the other lender(s);
- payment blockages (ie: under what circumstances can the borrower make payments to which creditor); and
- how will access to collateral be dealt with in the event of an enforcement?

(i) Priority Issues

Possibly the most critical component of an Intercreditor Agreement is the establishment of the relative priorities between the lenders. This will include the rights to payment and the ranking in respect of various classes of collateral.

Oftentimes, the lenders will agree upon both payment subordination and a security subordination. In the case of payment subordination, the agreement will delineate the order in which payment will be made to the creditors on account of the distinct obligations of the borrower to each creditor. For example, lenders will usually negotiate whether the senior lender will be entitled to charge default interest, be entitled to receive prepayment premiums and/or incur protective advances ahead of the junior lender.

Similarly, security subordination addresses the priority between the lenders respecting the security held by each lender for its debt. Typically, each lender will have security over all assets of a borrower and the Intercreditor Agreement addresses the question of which lender will rank in priority in the event of an enforcement scenario.

However, there are occasions when lenders may have security over different assets. For example, an operating lender may take a first ranking position over working capital assets such as cash, inventory and receivables and an enterprise value lender may have a first ranking position over all other assets. In such a circumstance, the concern of each lender will centre on issues of access to the collateral they have priority to in the event of an enforcement.

Another common feature of an Intercreditor Agreement is a standstill provision. The purpose of such a provision is to give a senior lender control over any enforcement process by restricting the circumstances in which a junior lender may exercise its remedies after a default by the borrower. The negotiations will usually revolve around the length of the standstill period and what steps the junior lender can take during such period (ie: make demand, issue enforcement notices, undertake appraisals etc.).

(ii) Payment Blockages

Typically, a senior lender will want to restrict the right of a junior lender to receive payments from a borrower until the senior debt has been repaid.

A restriction on the repayment of principal is usually accepted as a given by a junior lender. However, restrictions on the payment of interest can vary depending upon the respective bargaining power of the lenders involved.

Understandably, the payment blockage provision tends to be one of the most heavily negotiated provisions of the Intercreditor Agreement. Discussions tend to focus on what is the triggering event for the payment blockage and what will be the frequency and length of the blockage. In cases of a monetary default by a borrower to the senior lender, it would be unusual if any payment were permitted to the junior lender until the monetary default is cured. With respect to non-monetary covenant type breaches, it is more usual to have a 120 to 180 day blockage period. Understandably, another point of negotiation for the junior lender in such circumstances is the right for the borrower to pay catch up payments to the junior lender after a blockage period.

(iii) Access to Collateral

After everything has gone horribly wrong and realization proceedings have been initiated by one or more lenders, the issue of access to the secured collateral takes on a whole new level of importance.

For example, one can envisage a scenario where an operating lender may want an enterprise lender to allow it to have access to the premises for the purpose of completing work in process and thereby maximize the value of its security interest in the inventory of the borrower. Of course, in order to process such work in process, the operating lender will need to use the production equipment over which the enterprise value lender has a first ranking security. An agreement will need to be reached on what compensation will be paid to the enterprise lender and confirming that the operating lender will be responsible for insurance, utilities and other operating costs.

While the above issues are common to most Intercreditor Agreements, the unique nature of each business and the variety of financing relationships available will, of necessity, make each Intercreditor Agreement transaction specific.

IV. Employees

Employees are usually one of the last stakeholders to receive official word of a pending business restructuring or failure.

To be sure, there will be gossip around the water cooler but it is not usually in the best interests of a business owner to confirm financial difficulties before a plan has been formulated to deal with these difficulties. To do so risks the real prospect of mass employee defections.

In 2008, in an attempt to better protect employees in the event of a business failure, the federal government enacted the *Wage Earner Protection Program Act* ("**WEPPA**").

As the legislation deals with circumstances where there is an insolvency of a business, and by definition not enough assets to satisfy the debts owing to the various stakeholders, someone's ox is being gored by WEPPA and this someone is the secured creditor.

Essentially, the WEPPA regime provides for a first ranking claim of $2000 per employee over the current assets of an employer who is bankrupt or subject to a receivership. This $2000 per employee super-priority has the potential to directly and adversely affect secured creditors.

The WEPPA entitlement is comprised of a two-step process:

- employees whose employer is bankrupt or subject to a receivership may submit their claims for eligible wages to Service Canada for payment.[10] The current maximum amount payable is approximately $3250; and
- the federal government assumes the interests of the employees against the insolvent estate of the employer who is bankrupt or subject to a receivership. This becomes a super-priority claim ahead of all creditors limited to $2000 per employee and is only over the current assets of the employer. The definition of "current assets" in the BIA includes cash, cash equivalents – including negotiable instruments and demand deposits – inventory or accounts receivable, or the proceeds from any dealing with those assets. [11]

As a result, a secured creditor who holds security over the current assets of the debtor company will stand behind all employees up to the per employer super-priority limit of $2000. This constitutes a substantial shift in the priority rankings.

In response to the implementation of the WEPPA regime, secured creditors have tended to become more proactive in monitoring the financial performance of their debtors. For example, many secured creditors are requiring as part of their loan arrangements various protective covenants such as the requirement that a debtor use a third party payroll system and permit spot audits with respect to payroll remittances.

It should be noted that WEPPA has no application in circumstances where a debtor seeks protection from its creditors under either the *Companies Creditors Arrangement Act* or the proposal provisions of the BIA. Accordingly, in the event that the employment of an employee is terminated as part of such a proceeding, there is no WEPPA protection and employees may be forced to seek recourse against the directors of the insolvent corporation for unpaid wages and vacation pay.

V. Landlords

Frustration. This is perhaps the most common sentiment expressed by a landlord who has experienced the business failure of a tenant that results in an insolvency, bankruptcy or enforcement proceeding by a secured creditor.

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[10]"Eligible Wages" are defined in s.2(1) of WEPPA as wages earned during the six months prior to the date of bankruptcy or the date of the appointment of a receiver. Wages includes salaries, commissions, compensation for services rendered, vacation pay, severance pay, termination pay, gratuities, disbursements for travelling salespeople, production bonuses and shift premiums.
[11]See s.2 BIA.

This sentiment is easy to understand. One minute the landlord can rely upon the carefully crafted provisions of its lease to protect itself and its premises - the next minute - the landlord is served with notice that the tenant has obtained an order protecting itself from action by its creditors, or even worse, that it has already become a bankrupt or has been put into receivership.

It is a gross understatement to say that a landlord is at a distinct disadvantage in the race to the swiftest that ultimately dictates how successful it will be in recovering money in the event of a business failure. Other than the payment of rent, there is usually very little contact and almost always no ongoing financial disclosure obligation (other than in the context of leases that are based on percentage sales).

In circumstances where there has been an event of default under a lease but no protective insolvency filing, there is an opportunity for a landlord to exercise its remedy of distress and, by so doing, defeat the interests of a secured creditor.

Distress is a combination of a statutory and common law self-help remedy entitling a landlord, prior to the termination of the lease, to seize, take possession of, and sell the goods and chattels (not fixtures) of a tenant located at the landlord's premises to satisfy arrears of rent.

At first blush, distress appears to be an ideal remedy. However, there are a number of restrictions set forth in both the *Commercial Tenancies Act* (Ontario) and at common law which a landlord must carefully navigate, including:

(a) while there is no requirement to give prior notice of the distress under the legislation, proper notice must be given to the tenant at the time the distress is taken;

(b) after giving notice of distress and taking possession of the chattels, but prior to marketing the chattels for sale, the landlord must wait five days and then must have the distrained goods appraised by two independent appraisers;

(c) when selling the distrained assets, the landlord must obtain "the best price available in the marketplace for them"; there is no specific requirement with respect to the process that must be following for the sale of the goods; however, the landlord can be exposed to liability for making an "improvident" sale;

(d) the landlord must be careful not to seize and sell an amount of the tenant's property that greatly exceeds the quantum of the tenant's arrears. This is an onerous and ambiguous restriction because it is clear that in order for the landlord to recover the full amount of rent in arrears and the cost of exercising its right of distress and marketing and selling the tenant's chattels, the distress will almost certainly have to provide a cushion and this should not subject the landlord to damages; however, if the distress is "excessive" (ie. the value of the distrained goods is unreasonably in excess of the amount in arrears) the landlord is exposed to the risk of liability damages. The question then becomes what is excessive in the circumstances;

(e) distress must be levied during daylight hours, that is, after dawn and before sunset; and

(f) chattels exempt from execution under the provisions of the *Execution Act* (Ontario) may not be distrained.

The right of distress is a unique right available to a landlord. In order for the landlord to lawfully exercise the right of distress, it is necessary that the landlord-tenant relationship remain intact until the completion of the distress. Accordingly, the tenant must be in possession of the premises and there must be arrears of rent due and payable to the landlord prior to the sale of the chattels and the application of the sale proceeds on account of the arrears of rent.

Although landlords and bailiffs have now become more sensitive to this point, it was formerly common practice for a landlord to purport to distrain by changing the locks on the premises. However, case law has made it clear that the changing of the locks by the landlord (without making arrangements for tenant access) is, in effect, a re-entry into the premises and termination of the lease, even if such action is purportedly for the purpose of securing the chattels on the premises. Once the lease is terminated the landlord loses its rights to distress and the tenant has the right to remove the chattels.

The other issue for a landlord exercising its right of distress is to determine who owns the chattels located on the premises. The landlord may not distrain on the chattels of any person except the tenant or other "person who is liable for the rent". The landlord is not entitled to chattels on the premises that were provided to the tenant on consignment or under a true lease.

Generally Speaking:

(i) except for chattels on the premises which are subject to a true lease (a lease which is not in the nature of a financing arrangement), the race is to the swiftest; in other words, priority goes to the party who first seizes the chattels; however, it must be noted that the Ontario Court of Appeal has held that a landlord's distress completed within three months of a tenant's bankruptcy can be considered a "fraudulent preference" if such distress is not completed in accordance with the statutory requirements, and that in such a case the proceeds of the distress belong to the trustee in bankruptcy, leaving the landlord with merely a preferred claim under the BIA. This results in wasted time, effort and expense on the landlord's part; [12] and

(ii) with respect to chattels leased pursuant to a true lease, title to the chattels is in the lessor and the landlord cannot gain priority by seizing the chattels.

Often, in attempting to exercise its right of distress, the landlord or its bailiff will encounter a difficult tenant that fervently objects to the act of distress. Such an uncooperative tenant may present the possibility for a physical confrontation and/or attempt to remove the goods from the premises. Needless to say, in such circumstances, the landlord must avoid physical confrontation in order to avoid exposure to liability for trespass and assault. The landlord also has to be aware of its right to hold the tenant and any other person who assists the tenant in fraudulently removing goods from the premises to avoid distress personally liable under the governing legislation.

Practically speaking, the "race to the swiftest" and corresponding incentive for the landlord on the one hand and a secured creditor on the other hand to seize the tenant's assets as soon as possible can have a counter-productive affect on each of the landlord, the tenant and the secured creditor, as it may result in the failure of the tenant's business that otherwise may have been in a position to work its way out of its financial difficulties through a proposal under the BIA, plan of arrangement under the CCAA, or some other "turnaround" measure.

It should be noted that the landlord cannot sue for rent until the distress has been completed (i.e. the goods have been appraised and sold). It should also be noted that if a deficiency remains after the goods subject to the distress have been sold, the landlord may sue for the deficiency, or terminate the lease for arrears of rent as a result of the fact that a deficiency remains.

In April of 2004, the Ontario Superior Court released its decision in *The Attorney General of Canada v. Community Expansion Inc. et. al.* However, this case was not reported until almost a year later. Boiled down, the decision in *Community* effectively characterizes landlords who have exercised their right of distress to be secured creditors and therefore

[12] Canadian Imperial Bank of Commerce v. Canotek Development Corp., [1997] O.J. No. 3735, 35 O.R. (3d) 247.

subject to the super-priorities created by the deemed trust provisions of the *Income Tax Act* **("ITA")**. [13]

The facts of the case are straightforward. A landlord distrained upon the assets of its tenant (a related party) for non-payment of rent and, in the first instance, the assets were sold to a related purchaser incorporated for the sole purpose of purchasing the assets. The landlord completed its distress by following the letter of the law and, ultimately, the assets were sold on by the related purchaser to an armslength purchaser with the proceeds of sale placed into an interest bearing account pending judicial determination as to the priority between the landlord and Canada Revenue Agency ("**CRA**").

As it turns out, the tenant had failed to remit four months of source deduction payments to CRA and the landlord initiated the distress to assist the tenant in avoiding payment. CRA took offense to the notion that distress defeats the deemed trust provisions under the ITA and argued that a distraining landlord should be treated the same as a secured creditor realizing upon its security.

The trial court, and subsequently the Court of Appeal, agreed with the CRA. It was found that although the landlord's right to distrain is not in and of itself a "security interest", once exercised, it creates a lien in favour of the landlord that constitutes a "security interest" and, as a consequence, the landlord becomes a "secured creditor" within the meaning of the deemed trust provisions of the ITA.

Specifically, the Court held that the trust does not attach to any particular assets so as to prevent their sale. Rather, the trust attaches to the proceeds of sale.

In practical terms, the decision in Community means that prior to commencing a distress a landlord must be concerned with the quantum of arrears owing by a tenant to CRA for unremitted source deductions and for unremitted HST. Until the ruling in Community, landlords accepted the fact that their distress would by subordinate to the debt owing by a tenant to the Province for what was then provincial sales tax but after Community, a landlord must also be concerned with unremitted source deductions.

For landlords, distress was once thought to be the best weapon in their arsenal against not only a defaulting tenant but also, if swiftly implemented, against a secured creditor and even a trustee in bankruptcy of a tenant. The decision in Community, by characterizing distress as a security interest and a landlord exercising distraint as a secured creditor, greatly reduces the utility of distress as an effective landlord remedy.

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[13] Ontario Court of Appeal [2005] O.J. No. 186, 137 A.C.W.S. (3d) 1241. Ontario Superior Court [2004] O.J. No. 5493, 136 A.C.W.S. (3d) 567.

VI. Shareholders

As one would expect, an owner of a failed business is the last in line to receive the remaining "equity" after all of the other stakeholders have received their respective entitlement. More often than not, there is nothing left to distribute to an owner.

Such a result is common but, in most cases, it is also avoidable. It is the rare business owner that does not contribute his or her own money into the business. Advances are often made to cover payroll or ensure a critical supplier is paid when no further room is available on the operating line. Unfortunately, in the majority of such cases, the monies are put into the company on an unsecured basis. Provided that security is taken contemporaneously with an advance of funds, there is no reason why a business owner cannot obtain the protection of being a secured creditor. [14] At least in this way, if the business does fail, the owner will rank ahead of unsecured creditors to the extent of his or her advances.

Whether it is a lack of understanding, an unwillingness to seek professional advice or some other reason, more often than not, I see business owners lose thousands and sometimes millions of dollars for want of a perfected security interest.

VII. Summary

When representing a stakeholder of a failed business enterprise, there are a series of questions that should be asked in order to assess the likelihood of recovery.

Specifically:

- Are there any monies owing to the Crown for source deductions or HST? If the amount owing for source deductions is modest but the HST arrears are significant, does it make sense to bankrupt the debtor and reverse the priority in favour of the Crown?
- Are there any secured creditors and, if so, what is the scope of the security interests held? If there are multiple secured creditors, do any of them have a PMSI interest and is there an intercreditor agreement that deals with the priority between these creditors or must recourse be had to the priority provisions found in the PPSA?
- When representing a landlord, the question will be – am I too late? If no steps have been taken by other stakeholders but an event of default has occurred under the Lease, consideration should be given to exercising the remedy of distress. If there is enough information available about asset values and the existence or non-

[14]Security taken for past advances can also be effective provided that sufficient time has passed to allow the security to season and not be considered a fraudulent preference in the event of a subsequent bankruptcy.

existence of super-priority claims, there may be an opportunity for a landlord to defeat the interests of a secured creditor.

- Typically, in non-union shops, there is limited scope for negotiation on behalf of an employee or even a group of employees. Employee entitlements are prescribed by statute and advice is usually limited to assisting with navigating the WEPPA benefits process and advising on potential recourse to directors for unpaid wages and vacation pay in situations where WEPPA is not available.
- Similarly, when representing a business owner who has no secured interest, the value proposition will only focus on ensuring that whatever enforcement actions are being undertaken by the stakeholders are being properly and efficiently conducted to maximize the opportunity for residual equity at the end of the day for the business owner.